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Classified By: ECON M/C Quanrud for reasons 1.5 (b) and (d).

¶1. (C) Summary: This year's annual update on Russia's investment trends includes a number of impressive headlines: record foreign direct investment (FDI) flows into Russia; record domestic investment; record sums raised by Russian companies through IPOs; and record outward investment by Russian companies. Investors of all stripes are jumping into a Russia boasting numerous advantages: its eighth year of strong GDP growth increasingly fueled by an ongoing consumer boom; a panoply of enviable macroeconomic indicators; ity; outstanding bottom line results for many companies; and the promise of more to come. American investment continues to bound ahead, bringing individual companies uncommonly high profit margins and helping bridge the "values gap" between the U.S. and Russian business communities.

¶2. (C) Whilt the trends are indisputably positive, the fact remains that both absolute levels of foreign and domestic investment as well as investment levels per capita are well below potential. Key perennial roadblocks to investment must still be addressed through further reform and liberalization, and investment levels must increase to improve efficiency, encourage diversification, and maintain growth as competitive pressures increase, energy prices soften, and capacity constraints worsen. While this past year has seen renewed efforts on the part of the current administration to appeal to investors through outreach, initiatives and incentives aimed at strengthening the high-tech and manufacturing sectors, much work will fall to the next administration to secure Russia's medium-term growth outlook. End summary.

Record Breaking Investment Levels

¶3. (SBU) The past year has witnessed a boom in foreign and domestic investment in Russia. According to the Central Bank of Russia, 2006 FDI came in at $28.7 billion, almost twice as much as 2005. The 2006 figures bring FDI to just under 3% of GDP. Significantly, Russia led its BRIC peers for the first time in this category, beating China's 2.66% of GDP, Brazil's 1.39% and India's 1.07%. FDI is also increasingly directed to a broader range of Russia's regions and sectors. Beyond the natural resource sectors, the lion's share of 2006 FDI went to metals, the financial sector, transport, real estate and services. Rosstat figures for 1Q07 indicate the boom

continues this year, as FDI increased 25% year-on-year to $9.8 billion. UNCTAD's 2007 study of FDI inflows over the period 2004-06 indicates that Russian inflows increased 94.6%, compared to China's negative 3.3%, Brazil's negative 2% and India's 44.4%.

Russian IPOs Draw Investors

¶4. (SBU) Investors also continued to show strong interest in Russian IPOs. Vastly improving on record IPO performance in 2005 ($4.3 billion raised), last year Russian companies launched 23 IPOs and raised almost $18 billion. In a decided shift from the previous drive to list almost exclusively abroad, 17 of the 2006 listing were in part or in full on Russia's two main exchanges, RTS and MICEX, representing a total of 34.8% of listed market share. The heavy weight IPO of 2006 was that of Russian state energy giant Rosneft, which raised over $10.4 billion. Steel giant Severstal came in second place with over $1 billion. Other companies include Magnit (retail), Raspadskaya (coal) and OGK-5 (electricity), each of which raised more than $300 million on local exchanges. PricewaterhouseCoopers forecasts that some 30-35 Russian companies will conduct IPOs in 2007, raising $20-25 billion.

U.S. Investment Continues to Grow,
and Have Positive Impact

¶5. (C) U.S. firms continued their strong march on the Russian market, with extremely positive results. According to a recent Ernst and Young survey commissioned by the American Chamber of Commerce, U.S. firms invested at least $24 billion between 2001-05 in Russia, with 50% of companies showing a

"better than budget" profit over the same period. For 2008, 41% of the companies surveyed expect turnover to increase by more than 100% over 2005, while an additional 29% expect it to grow by 50-99%. Average investment by companies entering the Russian market between 1989-1993 was $519 million per company from 2001-2005, while average investment of companies which entered the market between 1999-2006 totaled $55.5 million per company.

¶6. (C) In 2006, some of the larger U.S. company investment included: International Paper ($400 million to form a joint venture with Ilim Pulp); Guardian Industries ($260 million to construct a glass factory); Philip Morris ($600 million to expand a high-tech facility); General Motors ($115 million on a greenfield manufacturing facility); Dow (up to $20 million to establish control over polyurethane systems manufacturer Izolan); Cargill (up to $30 million to acquire a vegetable oil extraction plant and 25% of a sugar plant); ConocoPhillips (which increased its share in Lukoil from 16.4% to 20%); and Motorola ($2 million to open a brand shop in Moscow). These and many other companies are planning additional investments to take advantage of the favorable market. The Ernst and Young survey indicated that those companies which entered the market between 1989-1993 and are most comfortable here expect investment during the period 2006-2008 to be roughly $358 million.

¶7. (C) A separate AmCham survey confirmed that U.S. companies operating in Russia have been making a profound impact on their Russian employees and business partners, greatly contributing to bridging the "values gap." The survey revealed that Russian employees in American firms here increasingly come to expect transparency, fairness and accessibility to senior management. U.S. firms are strongly promoting charitable works among their employees in Russia, and are demonstrating ways to unlock Russian innovation better and faster. U.S. firms are seen by their employees as law-abiding, helping build a culture of accountability, and bringing top-line management models to their Russian

operations. Russian employees increasingly see law compliance, merit-based compensation, strong business ethics and social responsibility as necessary conditions of integration into the international business community.

Domestic and Outward Investment Also Up

¶8. (SBU) Domestic investment has also reached new heights over the past year. During 2006, RosStat estimates that domestic capital investment increased by 13.7% to $163.9 billion, or 16.7% of GDP. World Bank figures indicate that sectors attracting most of this investment in 2006 were transport and communications (26.8%), mineral resource extraction (17.3%), manufacturing (16.4%, 4.3% of which was metals), and real estate operations (11.5%).

¶9. (SBU) The World Bank and RosStat estimate approximately 20% growth in fixed capital investment over first four months of 2007, which suggests that investment growth this year will exceed the record 17.4% registered in 2000. Elevated investment, particularly in machinery, equipment, and construction materials manufacturing, led to a surge in 1Q07 industrial production, which RosStat estimated at 8.4%. Fitch Ratings indicated in January 2007 that the current recovery in domestic investment appears more sustainable than in the past, reflecting rising public investment, strong private sector balance sheets, easier access to financing from capital inflows and bank credit growth, tightening capacity utilization, and good growth prospects.

¶10. (SBU) Reflecting their very positive cash flows, Russians have invested more money abroad as well. Evraz's acquisition of Oregon Steel (the largest outbound transaction of 2006 at $2.3 billion), Stratcor, and Highveld Steel and Vandium; the RusAl, SUAL, Glencore aluminum merger; Norilsk Nickel's purchase of U.S.-based OM Group's nickel business; and acquisitions by telecoms, steel, banks and oil companies in Africa, Europe, and the former Soviet republics reached $13 billion last year. Russia is now the third largest foreign investor among developing countries.

Explaining the Boom

¶11. (SBU) Both foreign and domestic investors are drawn to

Russia by its continued strong macroeconomic fundamentals and the market potential of what is now the world's tenth largest economy. Principal attractions include enviably strong average annual GDP growth over the past 8 years of just under 7%, a federal surplus of 7.5% of GDP last year, low external debt (about 5% of GDP), enormous financial reserves, an increasingly strong ruble, improved investment ratings, a booming domestic market (10.7% increase in consumption in 2006) backed by rising average salaries and real disposable income, comparatively low wages, vast natural resources, and significant opportunities for building up badly decayed infrastructure.

¶12. (SBU) Increased investor confidence in the Russian economy is evidenced not only by raw investment figures. The financial story of 2007 - the pick-up in capital inflows - is further proof. Central Bank Chairman Ignatiyev stated in early June that net private capital inflows already reached $60 billion in the first five months of 2007, compared to $41.7 billion for all of 2006. While in the past, additional capital inflows were due to sharp increases in oil prices, 2007 inflows largely resulted from an increase in foreign borrowing by Russian corporations and foreign participation in Russian IPOs.

¶13. (SBU) Russia's equity and bond markets were attractive to investors in 2006, with the RTS index up for the year 70.8%. Sell-offs of emerging market stocks in 2007 as well as the

huge increase in equity investments on offer in Russia have contributed to an almost 10% decline year to date on the RTS index. Russia's EMBI spread has narrowed over the year to a range of 85-100, slightly worse than Mexico's 71-85, but well below Brazil's 139-155. Standard and Poors raised Russia's sovereign credit rating from BBB to BBB for foreign currency liabilities and from BBB to A- for national currency liabilities.

¶14. (SBU) Investor confidence surveys back up the positive outlook of domestic business. A 2007 study by the Russian Managers Association revealed that 90% of Russian business leaders surveyed believe the financial and economic situation of their companies will improve in the near future.

Could Be Much, Much Better

¶15. (SBU) As we noted last year, Russia's impressive strides in investment are tempered by the certainty that they could be even stronger. While the 2006 percent of GDP figures put Russia ahead of China for the first time, the stock of Russia's net FDI is still modest; the EBRD estimates that Russia received cumulative net FDI of just $61 per head from 1989-2005, compared with a Central and Eastern European average of $2,714. The Economist estimates that even by 2011, stock of inward FDI will barely exceed 12% of GDP.

¶16. (C) Factors limiting growth are numerous, and include administrative barriers, uneven application of laws and regulations, capacity constraints, the slow pace of institutional change, the impact of real ruble appreciation leading to a decelerating pace of economic expansion, and corruption, which Fitch analysts point out is the worst of any investment-grade country (Transparency International's 2006 rating put Russia at 121/163). According to a survey by the Economist Intelligence Unit commissioned by RusAl, Western investors are most concerned about lack of corporate governance, transparency and appropriate business ethics. Despite much debate and discussion, Russia is still struggling over proposed legislation governing investment in so-called "strategic sectors" and corresponding amendments to existing subsoil legislation that will eventually give investors greater clarity. And although broad policy continuity is likely, political uncertainty over the election period is likely to be a factor affecting short-term investment decisions.

¶17. (C) Russia will need further structural reform and investment to improve efficiency, productivity, and maintain growth as competitive pressures increase, energy prices soften, and capacity constraints worsen. At just under 17% of GDP, domestic investment levels are still significantly behind widely-recognized benchmarks for fast-growing transition economies. Higher investment rates would unquestioningly help sustain GDP growth and promote additional economic diversification over the medium term.

What has been marked about Russia under Putin is the government's complacency with solid (i.e. 7% average annual) growth rates, while clearly foregoing the opportunity for the kind of super growth rates seen in China and India.

¶18. (SBU) But things may be changing in that regard. Over the past year, the GOR has rolled out a new package of legislative and policy initiatives designed to stimulate investment in sectors to promote economic diversification and reduce reliance on resource extraction. The measures are particularly focused on encouraging the high-tech and manufacturing sectors, and include changes in tax rules (more favorable amortization write offs and tax breaks for innovation activities), increased state funding for science and R&D, creation of a state development bank (ref B), the creation of special economic zones (ref C) and technoparks, public-private venture capital funds, and public-private

partnerships for development of large infrastructure projects.

¶19. (SBU) The Russians are also trying for the first time in half a decade to improve their presentation to the foreign investment community. The GOR also greatly increased its presence at this year's World Economic Forum in Davos (after a near no-show performance the previous year), and pulled out all the stops to attract thousands of business and government representatives to the June 2007 St. Petersburg Economic Forum. At the latter, President Putin highlighted the role of foreign investment in Russia, singling out the electricity and infrastructure sectors as two in which Russia particularly welcomes foreign participation. Presidential hopeful First Deputy Prime Minister Sergey Ivanov said that foreign investors would play a key role in the economy's development. Notably, all major administration players met with groups of CEOs, including President Putin, First Deputy Prime Ministers Sergey Ivanov and Dmitry Medvedev, Economy Minister Gref and Finance Minister Kudrin.

Comment

¶20. (C) The dichotomy we presented in last year's investment wrap-up continues (ref A): while the investment climate is far from ideal and certainly carries risk (particularly in sectors considered strategic), both foreign and domestic investors are seemingly inexorably drawn to the Russian market by its phenomenal profit margins and significant forward potential. The investment inflows are in many cases, as demonstrated by AmCham's values survey, encouraging positive shifts to business principles of transparency, rule of law, and good corporate governance. Increased Russian investment outflows to places like the U.S. and Europe are also spurring positive changes in the way Russian companies conduct business at home.

¶21. (C) It remains to be seen if the incentives put in place to encourage greater foreign and domestic investment in high tech and manufacturing sectors (assuming they continue in the next administration) will help diversify the economy and better insulate it from price fluctuations in the natural resource sectors. Certainly further structural reform, more vigorous action against corruption, and clear legislative and regulatory rules of the road will be key to attracting the huge sums of additional investment still needed to make Russia's economic growth sustainable in the medium-term.
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